NOTES

THE POWER OF THE SENATE TO UNSEAT AN OFFICER WHOSE APPOINTMENT IT HAS CONFIRMED AND NOTIFIED THE PRESIDENT THEREOF—President Hoover made appointments of certain men to office as members of the Federal Power Commission. These appointments were confirmed by the United States Senate and three of the appointees were inducted into office. These three members notified some of the clerical staff of the old Power Commission, of which they were members, that their services would be temporarily retained by the new Power Commission. Three members of that staff, however, did not receive such notices, with the result that the Senate requested the President to return the approved credentials of these three appointees to membership on the Federal Power Commission, which the President refused to do on the ground that the attempt to reconsider these appointments after the Senate had consented thereto, had notified the President thereof, and the men had taken the oath of office was an unconstitutional invasion of the executive power of removal. Thereupon, the Senate returned the names of the three officers to its appropriate committee, the Committee reported without recommendation the names of the men, and the Senate thereupon again confirmed two of the men but refused to confirm the third one. The Senate also adopted a resolution for the employment of counsel to work either in conjunction with, or independently of, the United States Attorney for the District of Columbia in bringing *quo warranto* proceedings against this officer of the Federal Power Commission to test in the courts his right to hold office.[1]

This note is not concerned with either the right or the political expediency of the action taken by this quorum of the Federal Power Commission in giving notice to some of the employees of the old Power Commission, which had been superseded by the law creating the new Power Commission, that they would be temporarily retained on the public payroll pending consideration of the desirability of their permanent appointment and failing to give such notice to three other employees. In other words, the writer does not desire to enter into the merits of that controversy and this note deals only with the single question of the constitutional power of the Senate to unseat by recon-

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[1] For the essential Senate history of this case see letter of President refusing to return the nominations, 74 CONG. REC. 1887 (1931); and for statement to the public of his reasons for refusing to do so, *ibid.* 1962. For opinion of Attorney-General advising the President that Senate had no constitutional power to require return of the nominations, *ibid.* 2992. Debate, etc., on return of the names to the Senate Executive Calendar, *ibid.* 1887-1893. For institution of *quo warranto* proceedings, see Senate Resolution 415. For resolution to bring *quo warranto* proceedings against one member who was not reconfirmed, *ibid.* 4036; 65 U. S. L. Rev. 121, 126 (1931).

sideration the appointment of an officer of the United States which it has confirmed and which officer has been inducted into office.

It must be admitted since the *Myers* case,[2] that Congress may not constitutionally limit the President's power of removal of executive officers of the United States. I use the words "executive officers" advisedly, for, as stated by James M. Beck, who represented the United States in the *Myers* case:

> "That decision does not decide whether or not there may not be a class of officers who are not in strictness executive officers. For example, the Federal Trade Commission is chiefly a fact-finding commission, to aid Congress in formulating legislation. The Interstate Commerce Commission is a fact-finding commission which discharges the so-called legislative duty of imposing reasonable rates upon carriers. The Comptroller General is regarded as the special representative of Congress in seeing that its appropriations are faithfully disbursed.
>
> "Can the President remove such *quasi*-legislative officials? This decision is not conclusive upon this point and properly so; for no case of this character was before the Court." [3]

Whether the members of the Federal Power Commission be viewed as strictly executive officers or, to use Mr. Beck's phrase, *quasi*-legislative officers, the statute creating their office did not attempt to place any restriction on the President's power to remove them.[4] The constitutional question concerning the right to remove them is brought into the case through the claim on the part of the Senate that it has the authority to reconsider the vote by which it agreed to the appoinments and then to refuse to confirm the appointments. The validity of this claim is the single issue discussed in this note.

The Constitution provides that "each House may determine the rules of its proceedings" [5] and with respect to nominations and notices of confirmations the Senate has adopted rules as follows:

> "When a nomination is confirmed or rejected any Senator voting in the majority may move for a reconsideration on the same day on which the vote was taken, or on either of the next two days of actual executive session of the Senate; but if a notification of the confirmation or rejection of a nomination shall have been sent to the President before the expiration of the time within which a motion to reconsider may be made, the

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[2] Myers v. United States, 272 U. S. 52, 47 Sup. Ct. 21 (1926).

[3] New York Times, Nov. 7, 1926, at 15.

[4] Act June 23, 1930, 46 STAT. 797, 798 (1930), 16 U. S. C. A. § 792 (Supp. 1930).

[5] Article I, § 5.

> motion to reconsider shall be accompanied by a motion to request the President to return such notification to the Senate. Any motion to reconsider the vote on a nomination may be laid on the table without prejudice to the nomination, and shall be a final disposition of such motion.
>
> "Nominations confirmed or rejected by the Senate shall not be returned by the Secretary to the President until the expiration of the time limited for making a motion to reconsider the same or while a motion to reconsider is pending unless otherwise ordered by the Senate."[6]

When the Senate confirmed the appointments to the Federal Power Commission the President was officially notified thereof before the expiration of the period within which the Senate could—under its rules—entertain a motion to reconsider the vote consenting to the nominations and three of the appointees qualified by taking the oath of office and entering upon the performance of their duties. The motion to reconsider was made in the Senate before the expiration of the next two days of actual executive session and was properly accompanied by a motion to request the President to return the notifications to the Senate—all in accordance with its rules.[7]

It must be admitted at the outset that there are no judicial precedents exactly in point for it seems that in all our history no question involving this question has reached the courts as to the authority of the Senate to confirm the nomination of a person to an office and then to reconsider the vote and refuse to consent to the nomination after the individual had been appointed and qualified during the interval between the confirming vote with official notice to the President thereof and the motion to reconsider the vote. Neither is any light thrown on the question by the proceedings of the Constitutional Convention of 1787.

A case having some bearing on the question is that of *United States* v. *Le Baron*.[8] In that case one Beers was nominated in April, 1850, by the President to the Senate as deputy postmaster at Mobile. The nomination was confirmed by the Senate and the commission had been made out but not transmitted to Beers on the date when the surety bond sued upon was given. It was contended on behalf of the surety that the bond was ineffective in that Beers was not legally a deputy postmaster when the bond was given. Said the court:

> "When a person has been nominated to an office by the President, confirmed by the Senate, and his commission has been signed by the President, and the seal of the United States affixed

[6] Rule XXXVIII, Standing Rules of the Senate.

[7] Attorney General Mitchell's opinion of January 10, 1931, 74 CONG. REC. 4041 (1931).

[8] 19 How. 73 (U. S. 1856).

thereto, his appointment to that office is complete. Congress may provide, as it has done in this case, that certain acts shall be done by the appointee before he shall enter on the possession of the office under the appointment. These acts then become conditions precedent to the complete investiture of the office; but they are to be performed by the appointee, not by the executive; all that the executive can do to invest the person with his office has been completed when the commission has been signed and sealed; and when the person has performed the required conditions his title to enter on the possession of the office is also complete."

Of course, this case is not exactly in point for the reason that no motion to reconsider the confirming vote was entered in the case of Beers, but can it reasonably be argued that such a motion entered in accordance with the rules of the Senate after the President has signed the commission, delivered it to the appointee, and the appointee has performed the only condition precedent—the taking of the oath of office—to complete title to the office must operate to change the rule?

The argument for the affirmative of this question was summarized in the Senate as follows:

"It seems to me that an analysis of the situation would lead to this conclusion: It is the affirmative vote of the Senate, in its finality, which gives validity to a confirmation. A notification to the President is merely evidence of the action taken by the Senate. If the notification goes forward within the 2-day period, it simply serves to notify the President that the Senate has voted affirmatively. But always it is conditioned upon the power of the Senate to reconsider within the prescribed time, namely, two days of actual executive session. If this notice went forward, in the meantime, it being merely evidence of the action taken by the Senate, it was accompanied with the condition that the Senate reserved unto itself the vested power to reconsider within the prescribed period.

"It seems to me the notification to the President is of like consequence in this situation, it merely being evidence of the vote taken by the Senate and that vote being subject to the right of the Senate to reconsider." [9]

This argument cannot be reconciled with the above quotations from the opinion in the *Le Baron* case. Furthermore, the same court has held that when a bill has passed both Houses of Congress, has been signed by the presiding officers thereof, and has been signed by

[9] 74 CONG. REC. 1479 (1931). See also *ibid.* 1480, where a reference was made to THROOP, PUBLIC OFFICERS (1892) § 89, but it seems that this section has no bearing on the question at issue.

the President, such bill has become a law which cannot be changed except as provided in the Constitution.[10] It seems logical to argue that when the Senate has confirmed a nomination made by the President, the President has issued the commission, and the appointee has performed such acts as are necessary to invest himself with the office, the title thereto is complete and that the officeholder cannot be removed therefrom except as provided in the Constitution. The attempt of the Senate to do so under the guise of reconsidering its vote within two actual days of executive session as provided in its rules is not a method so provided in the Constitution. True, the Senate power to make rules is provided in the Constitution, but this does not mean that such rules as the Senate may make are constitutional. It seems that the same principles of interpretation must be applied to Senate rules with respect to their constitutionality as have been applied by the courts in testing the constitutionality of a statute enacted by Congress. If any rule of the Senate cannot meet such a test, it must be held in excess of the powers of the Senate and if the *quo warranto* proceedings authorized and directed by the Senate are pressed to test the right of the confirmed and rejected member of the Power Commission to the office in question, we shall probably learn that this particular rule of the Senate cannot be upheld in its attempted application.

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EQUITABLE CONVERSION BY CONTRACT FOR SALE OF REALTY—APPLICATION IN TAXATION CASES—Recent decisions [1] indicate a continuing uncertainty as to the nature of equitable conversion by contract of sale as a ground for rendering the vendor's interest subject to a transfer tax. This situation, in view of the now more or less well-settled rule in the case of equitable conversion by will,[2] would seem to justify a re-examination of the cases to discover the reasons

[10] *Field v. Clark*, 143 U. S. 649, 12 Sup. Ct. 495 (1892).

[1] For example: *In re* Wolcott's Estate, 94 Misc. 73, 157 N. Y. Supp. 268 (1916); *In re* Russell's Estate, 119 Misc. 12, 194 N. Y. Supp. 837 (1922); Paul's Estate, 14 Pa. D. & C. 251 (1930), *aff'd*, Pennsylvania Supreme Court, March, 1931 (Fraser, *C. J.*, and Maxey, *J.*, dissenting).

[2] Frick v. Pennsylvania, 268 U. S. 473, 45 Sup. Ct. 603 (1925); *In re* Hogg's Estate, 284 Pa. 1, 130 Atl. 240 (1925); *In re* Robinson's Estate, 285 Pa. 308, 132 Atl. 127 (1926). *Contra:* Land Title & T. Co. v. South Carolina Tax Comm., 131 S. C. 192, 126 S. E. 189 (1925). Note (1912) 61 U. OF PA. L. REV. 109; (1925) 73 U. OF PA. L. REV. 439. Decisions in such cases, while persuasive as to the general theory of conversion, are of course not controlling in the situation considered by this note. In theory, conversion by will does not occur until the death of the decedent, while the so-called conversion by contract dates from the execution of the contract (before the death of the party whose estate it is sought to tax).

for or against the application of the doctrine under such circumstances.

The concept of "equitable conversion" seems to have been introduced into the common law by Lord Eldon. In the case of *Seaton* v. *Slade*[3] he expressed it in the form which has now received common acceptation:

> "The effect of a contract for purchase is very different at law and in equity. At law, the estate remains the estate of the vendor, and the money, that of the vendee. It is not so here. The estate from the sealing of the contract is the real property of the vendee."

That this was not a mere accidental statement is shown by the case of *Paine* v. *Meller*,[4] decided the previous year, which indicates that Lord Eldon realized the implications of his statement and was willing to regard equitable conversion as a principle general in scope,[5] and not a mere description of the result in the case he was then considering (*viz.* burden of loss due to fire).

Earlier cases, while recognizing an alteration in the rights of the parties to the contract of sale for certain purposes from the time of the execution of the contract, do not go to the extent of supporting Lord Eldon's generalization.[6] Since *Seaton* v. *Slade* literally hundreds of cases fixing the respective rights of the vendor[7] and vendee[8]

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[3] 7 Ves. Jr. 268, 274 (1802) (specific performance decreed against the vendor).

[4] 6 Ves. Jr. 349 (1801).

[5] ". . . if the party to the contract has become in equity the owner of the premises *they are his to all intents and purposes.* They are vendible as his, chargeable as his, capable of being encumbered as his; they may be devised as his; *they may be assets;* and they would descend to his heirs." *Ibid.* at 352. (Italics the writer's.)

[6] Vendee may compel specific performance if contract is a proper one for such performance. Bubb's Case, Freem. Ch. 41 (1678); Baden v. Pembroke, 2 Vern. Ch. 213 (1690). As between executor and heirs-at-law of vendor, purchase money passes to executor, but heirs are bound to convey legal title of land to vendee. Bubb's Case, *supra;* Mayer v. Gowland, Dick. 563 (1779); Smith v. Hibbard, 2 Dick. 731 (1789). If contract is specifically enforcible, vendee's interest is realty and passes to heir-at-law rather than to executor. Davie v. Beadsham, 1 Ch. Cas. 39 (1663); Greenhill v. Greenhill, Prec. Ch. 320 (1711); Milner v. Mills, Mos. 123 (1729); Alleyn v. Alleyn, Mos. 262 (1730); Langford v. Pitt, 2 P. Wms. 629 (1731); Potter v. Potter, 1 Ves. Sr. 437 (1750). But if not specifically enforcible, then money laid out for purchase passes to executor. Green v. Smith, 1 Atk. 572 (1738). Vendor has equitable lien for purchase price. Pollexfen v. Moore, 3 Atk. 272 (1745). Husband of vendee entitled to curtesy in money to be laid out in land under executory contract of sale. Sweetapple v. Bindon 2 Vern. Ch. 536 (1705).

[7] Vendor's interest is personalty and passes to personal representative. Brown v. Ide, 109 Conn. 307, 147 Atl. 4 (1929); Griffith v. Stewart, 31 App. D. C. 29 (1908), *aff'd*, 217 U. S. 323, 30 Sup. Ct. 528 (1910); Rhodes v. Meredith, 260 Ill. 138, 102 N. E. 1063 (1913); Persico v. Guernsey, 129 Misc. 190, 220 N. Y. Supp. 689 (1927); *In re* Denning's Estate, 112 Ore. 621, 229 Pac. 912 (1924); Helsel's Estate, 255 Pa. 612 (1917); 3 POMEROY, EQUITY JURISPRU-

under a contract of sale [9] have found their way into the reports, and whether modern courts have been impressed by the aptness and exactness of the term or have merely been dazzled by its rhetorical brilliance and inclusiveness, it is nevertheless true that in practically every case they have been content to rest the result reached upon the principle of "equitable conversion" rather than attempting, as did the early cases, to seek out some specific ground in equity or in law for granting or refusing the relief sought.[10] It is significant, however, that a search of the reports since 1802 reveals no case [11] where

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DENCE (4th ed. 1918) § 1164; 2 STORY, EQUITY JURISPRUDENCE (14th ed. 1918) § 1092. Land will not pass under vendor's later devise of land or of real estate. Elliott v. Fisher, 12 Sim. 505 (1842). *Contra:* Klock v. Buell, 56 Barb. 398 (N. Y. 1868). Some decisions hold that if agreement of sale is purely executory and in no way binds vendee to complete purchase, interest of vendor remains unchanged and at death passes to heirs as realty. Sheeby v. Scott 128 Iowa 551, 104 N. W. 1139 (1905); Vendor may not give a valid deed or mortgage of property to one having knowledge of vendee's equities though he may assign his interest under the contract. Ellis v. Jeans, 7 Cal. 409 (1857); Bailey v. Alleghany National Bank, 104 Pa. 425 (1883); Rose v. Watson, 10 H. L. Cas. 672 (1864). Land not subject *as land* to lien of judgment against the vendor. Pasquay v. Pasquay, 235 Ill. 48, 85 N. E. 316 (1908); Stockfleth v. Britten, 105 N. J. Eq. 3, 146 Atl. 583 (1929).

[8] Vendee's interest is considered realty and passes to heirs rather than to personal representative. Flomerfelt v. Siglin, 155 Ala. 633, 47 So. 106 (1908); Bowen v. Lansing, 129 Mich. 117, 88 N. W. 384 (1901); Harney v. Donohoe, 97 Mo. 41, 10 S. W. 191 (1888); *In re* Edgewater Road in City of New York, 138 App. Div. 203, 122 N. Y. Supp. 931 (1910), *aff'd*, 199 N. Y. 560, 93 N. E. 1120 (1910); *In re* Kelleher's Estate, 133 Misc. 581, 232 N. Y. Supp. 680 (1929). Vendee must bear fire loss even though not in possession. Marks v. Tichenor, 85 Ky. 536, 4 S. W. 225 (1887); Dunn v. Yakish, 10 Okla. 388, 61 Pac. 926 (1900); Morgan v. Scott, 26 Pa. 51 (1856); and any insurance on the property is regarded as for his benefit. Phinizy v. Guernsey, 111 Ga. 346, 36 S. E. 796 (1900); State Mutual Fire Insurance Co. v. Updegraff, 21 Pa. 513 (1853); 5 POMEROY, *op. cit. supra* note 7, § 2283. *Contra:* Raynor v. Preston, 18 Ch. D. 1 (1881) (but with strong dissent by James, L. J.). Vendee may execute valid mortgage of property subject to rights of vendor who holds the legal title as security for payment of purchase money. Flomerfelt v. Siglin, *ibid;* Bowen v. Lansing, *ibid.* Surplus from foreclosure sale made after mortgagor's death is treated as realty. Dunning v. Ocean National Bank, 61 N. Y. 497 (1875); and mortgagor's widow is entitled to dower even though she was a party to the mortgage. Kitchens v. Jones, 87 Ark. 502, 113 S. W. 29 (1908). The title is subject to the lien of a judgment against him in jurisdictions where an equitable interest may be so charged. Rand v. Garner, 75 Iowa 311, 39 N. W. 515 (1888); but even where this is not permitted, vendee's interest may be charged and property sold to satisfy the judgment. Doe *ex. dem.* Cooper v. Cutshall, Smith 128 (Ind. 1848). Vendee may maintain partition. Longwell v. Bentley, 23 Pa. 99 (1854); Vendee, if in possession, may maintain trespass q. c. f. even against vendor. Smith v. Price, 42 Ill. 399 (1866). Vendor is liable as trustee for deterioration of the property. Clark v. Ramsey (1891) L. R. 2 Q. B. 456.

[9] In addition, of course, there is the right of specific performance in the vendee, and (under certain circumstances) in the vendor, and the ordinary action at law, by either party for damages for breach of contract.

[10] See, for example: Semmler v. Beulah Coal Mining Co., 48 N. D. 1011, 188 N. W. 310 (1922); *In re* Denning's Estate; *In re* Helsel's Estate, both *supra* note 7.

[11] Excepting, of course, certain of the taxation cases, hereinafter discussed.

the court's decision (as distinguished from the court's language) has extended [12] the application of the alleged conversion to a situation in which the same result would not have been obtained prior to that time, but explained on other grounds without reference to a "conversion."[13]

But although courts have, practically without exception, accepted the doctrine of equitable conversion as a "reason," there has been equal unanimity in their insistence that not in all cases of a contract of sale does a "conversion" occur. It must be a contract that equity will specifically enforce; [14] and if that be improper because of defects in the vendor's title,[15] the statute of frauds,[16] or the existence of any other bar to a decree of specific performance,[17] no conversion takes place.[18] A contract of sale, then, does not "convert" the property, nor is it strictly true, as a recent decision suggests,[19] that "the powers of a court of equity are invoked to do this." More accurately, the vendee, by reason of the form and terms of the contract and the situation of the parties, has certain remedies, legal and equitable, against the vendor in the event of breach. Normally he may claim specific performance, but if the contract does not admit of this or any other equitable remedy he must be content with an action at law. Likewise the vendor has such legal or equitable rights under the contract as its terms and the surrounding circumstances confer.

Where the vendee's (or vendor's) interest under the contract is in dispute between his heirs-at-law and his personal representative

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[12] Except by a process of simple logical deduction from general principles already well established at that time.

[13] Compare the results in the modern cases, *supra* notes 7 and 8, with cases decided before the time of Lord Eldon, *supra* note 6. A contrary view is indicated by POMEROY, SPECIFIC PERFORMANCE OF CONTRACTS (3d ed. 1926) § 314. ". . . The vendee is looked upon and treated as the owner of the land; an equitable estate has vested in him commensurate with that provided for by the contract. Although the vendor remains owner of the legal title, he holds it as a trustee for the vendee to whom all beneficial interest has passed. The consequences of this doctrine are all followed out." If this language be interpreted as supporting Lord Eldon's generalization, it is not supported by the cases that the author cites. Such an interpretation of this language, however, is rendered doubtful by the same author's language elsewhere. See, for example, POMEROY, *op. cit. supra* note 7, §§ 1161, 1166.

[14] Rodisch v. Moore, 266 Ill. 106, 107 N. E. 108 (1914); *In re* Bernhard's Estate, 134 Iowa 603, 112 N. W. 86 (1907); Ingraham v. Chandler, 179 Iowa 304, 161 N. W. 434 (1917); Keep v. Miller, 42 N. J. Eq. 100, 6 Atl. 495 (1886).

[15] Mackey v. Bowles, 98 Ga. 731, 25 S. E. 834 (1896); *In re* Thomas, 34 Ch. D. 166 (1886).

[16] Mills v. Harris, 104 N. C. 626, 10 S. E. 704 (1890).

[17] Wittingham v. Lighthipe and Traphagen, 46 N. J. Eq. 429, 19 Atl. 611 (1890); Kerr v. Day, 14 Pa. 112 (1850).

[18] It should be observed that these are bars as between the vendor and the vendee.

[19] Paul's Estate, *supra* note 1.

the courts are called upon to determine the preferable mode of distribution of the decedent's rights. A regard for strict legal symmetry would counsel a distribution based upon the existence or non-existence of the right of specific performance in the given case,[20] and this is in fact the prevailing view.[21] This result, however, is predicated not on any theory of conversion,[22] but upon what the court deems the fairest rule of distribution in view of the outstanding rights, legal and equitable between the parties to the contract. There are, moreover, cases,[23] where a quite different rule of distribution is adopted, without regard to the existence of a right to specific performance. Cases involving the doctrine in deciding questions of dower and curtesy are similarly explainable.

It has been pointed out, however, by Justice (then Dean) Stone,[24] Dean Pound,[25] and others [26] that the use of the descriptive appellation "equitable conversion" as applied with respect to the rights of parties to the contract as between each other or between those in privity with either,[27] is, although historically unsound and as a practical matter inexact and confusing, usually harmless, and its application rarely makes any difference in result. Where, however, a third person is attempting to invoke the doctrine the exact meaning of the term is no longer inconsequential, and hence its use must be either adopted or rejected.

This problem is presented in perhaps its clearest form where a state seeks to subject a decedent vendor's or vendee's interest under the contract to the application of a state transfer tax—it being well settled that real property, as such, is taxable only at its situs.[28] Where the decedent is vendor under an executory contract for the sale of foreign realty, is his interest in the property still realty, hence non-taxable except at the situs of the property, or does the doctrine

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[20] For a decree of specific performance against the vendor to be effective, the heir-at-law must be decreed to convey the legal title to the land, whereas the purchase price as personalty goes to the administrator. The term "equitable conversion" is, roughly, expressive of this result. But where no right to specific performance is involved, it is said that no conversion occurs. Manifestly, this is because the vendor has merely a right to the purchase money which, clearly, is personalty, hence passes to the administrator.

[21] *Supra* notes 7 and 8.

[22] *Supra* note 6; Stone, *infra* note 24, at 377; Pound, *infra* note 25, 832; Ames, *Equitable Conversion* (1906) 19 HARV. L. REV. 233.

[23] Note appended to Keep v. Miller, 42 N. J. Eq. 100 (1886).

[24] Stone, *Equitable Conversion by Contract* (1913) 13 COL. L. REV. 369, 375.

[25] Pound, *Progress of the Law, 1918-1919* (1920) 33 HARV. L. REV. 813, 832.

[26] See, for example: *Ames, Equitable Conversion* (1905) 18 HARV. L. REV. 245; Foulke, *Equitable Conversion in Pennsylvania* (1910) 58 U. OF PA. L. REV. 455, 463-4.

[27] (*I. e.*, heirs, personal representatives, wife claiming dower, husband claiming curtesy, etc.)

[28] 2 COOLEY, LAW OF TAXATION (4th ed. 1924) § 447; GLEASON AND OTIS, INHERITANCE TAXATION (4th ed. 1925) 545.

of equitable conversion operate to render the vendor's interest personalty, hence subject to a tax at his domicile?

Equitable conversion—A "status" or a "description"

The fundamental question, of course, is (1) whether the property at the time of the decedent's death had lost its original status [29] (even though the contract was merely executory) and assumed a new status [30] (that which the contract, upon its performance would have brought about), or (2) whether the status of the property (to all intents and purposes) remained the same as before the contract was executed, and the term "equitable conversion" is merely descriptive of the *effect* of specific performance of the contract, *if* a court of equity should later deem the case a proper one for such a decree, and *if, as, and when* a party capable of asking specific performance *should in fact* seek it.

Probably the best statement of the former view is to be found in the decision of the New York court in *In re Boshart's Estate*: [31]

> "From the moment of the execution of the contract the property rights and interests of the parties and those claiming under them are fixed and determined by the equity rule whenever the same come in question, and on the death of the party the same rule determines whether his interest under the contract is real or personal, and therefore, to whom it shall pass, and there seems to be no reason why the same rule should not be applied in determining whether the transfer of the property is subject to a transfer tax."

Since the only question at issue in such a case is "how is the interest of the decedent fixed and determined," the court's argument is obviously a *petitio principii*. Modern scholars agree,[32] moreover, as has already been pointed out, that the rule of distribution is capable of a different explanation from that which the court is disposed to make of it. This and similar decisions [33] state the theory of a "changed status," but do not clarify or explain its basis. As previously observed, the history of the doctrine does not support this theory,[34] and though the New York court sees no reason why equitable

[29] It is the status of the property at the time of decedent's death that determines whether or not it is taxable. *In re* Swift's Estate, 137 N. Y. 77, 32 N. E. 1096 (1893); *In re* Sutton's Estate, 3 App. Div. 208, 38 N. Y. Supp. 277 (1896), *aff'd* 149 N. Y. 618, 44 N. E. 1128 (1896).

[30] In accordance with the maxim, "equity regards as done that which ought to be done."

[31] 107 Misc. 697, 177 N. Y. Supp. 567 (1919), *aff'd,* 188 App. Div. 788, 177 N. Y. Supp. 574 (1919).

[32] *Supra* notes 24 and 25.

[33] *Infra* notes 36, 39, and 43.

[34] *Supra* note 6.

conversion "should not apply" as a universal *rule,* there seems to be a paucity of reasons, in theory, why it should be considered as anything more than a *description of results* in those cases, involving merely the adjustment of the equitable rights of parties and those in privity with them, to which courts of equity had hitherto confined its application.[35] The reported cases thus far deciding the precise question are apparently in hopeless conflict. An examination of the facts involved therein, however, throws interesting light on the practical operation of the doctrine in tax cases, and incidentally upon the true nature of the vendor's and vendee's interests under the contract.

Nature of the Vendor's interest

There are three situations in which the problem as to the vendor's interest may arise: (1) Where the state is attempting to tax a resident vendor's interest in foreign property, in which event the application of the doctrine would render the vendor's interest taxable as intangible personalty.

Such a result was, in fact, reached in the recent case of *State ex rel. Hilton* v. *Probate Court of Ramsey County,*[36] where a Minnesota vendor's interest in a contract for the sale of Montana land was held subject to a Minnesota transfer tax.

(2) Where the taxing state seeks to tax a non-resident vendor's interest in property located within the state. Here the doctrine, if applied, would exempt this interest from being taxed as realty.[37] This result has been rejected in Michigan,[38] where the court has held

[35] *Supra* notes 6, 7, and 8. See BISPHAM, PRINCIPLES OF EQUITY (9th ed. 1915) § 307. "By equitable conversion is meant a change of property from real into personal, or from personal into real, not actually taking place, but presumed to exist only by construction or intendment of equity. 'Nothing', it has been said, 'is better established that this principle, that money directed to be employed in the purchase of land, and land directed to be sold and turned into money, are to be considered as that species of property into which they are directed to be converted; and this in whatever manner the direction is given, whether by will, by way of contract, marriage articles, settlement, or otherwise; and whether the money is actually deposited, or covenanted to be paid, whether the land is actually conveyed, or only agreed to be conveyed.' By this and similar declarations the judges do not mean to assert a solemn piece of legal jugglery without any foundation of common sense; but simply to lay down the practical doctrine that *for certain purposes of devolution and transfer,* and in order *that the rights of parties may be enforced and preserved,* it is sometimes necessary to regard property as subject to the rules applicable to it in its changed and not in its original state and although the change may not have actually taken place." (Italics the writer's.)

[36] 145 Minn. 155, 176 N. W. 493 (1920).

[37] Though it is possible that the law of the state may be such as to tax intangible personalty elsewhere than at the domicile of the creditor. 2 COOLEY, *op. cit. supra* note 29, § 455; GOODRICH, CONFLICT OF LAWS (1927) 108.

[38] Stanton's Estate, 142 Mich. 491, 105 N. W. 1122 (1905). The case of Dodge County v. Burns, 89 Neb. 922, 171 N. W. 922 (1911) is often cited as

the tax applicable on the theory that the vendor's interest was realty. There is language in the opinion of the Pennsylvania Supreme Court in *Arbuckle's Estate*[39] which supports the contrary view, but that language is no part of the actual decision in that case.

(3) Finally, where both the domicile of the vendor and the situs of the property are within the taxing state—here the vendor's interest should be taxable as personalty, not as realty. No decisions involving this situation are available though the reason for the scarcity of such cases is obvious.[40]

New York Cases show a peculiarly benevolent attitude towards the estate of deceased vendors. In *In re Baker's Estate*[41] and *In re Wolcott's Estate*[42] equitable conversion was held to be a mere descriptive term or "fiction," and the courts refused to invoke it to render a resident vendor's interest in foreign realty taxable in New York. However, under the converse situation, where the application of the doctrine would exempt a non-resident vendor's interest in a contract for the sale of New York land from the New York transfer tax, the courts have in two cases[43] approved such action by giving

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supporting the "status" theory under this situation. There, a New York vendor entered a contract for the sale of Nebraska land. Nebraska sought to tax his interest in the contract and the court denied the right to tax. "But", said the court, "we have not discovered any of these contracts or a copy thereof in the bill of exceptions; nor is the substance of any of them stated in or proved by the evidence. Counsel for the respective litigants, however, agree that we should consider the subject in dispute as though the contracts were real estate mortgages, and we therefore confine the discussion to that point of view." The court then proceeds to decide that the taxable situs of a mortgage is the domicile of the mortgagee. Though this case would have tested the "status" theory had all the facts been before the court, it is apparent from the portion of the opinion quoted that the case was decided on a quite different theory.

[39] 252 Pa. 161, 165, 97 Atl. 186, 187 (1916): "If, instead of testamentary direction by the (non-resident) decedent, that his said real estate in the city of Pittsburgh should be sold, he had entered into a written contract for the sale of it, his interest in it would have ceased to be realty from the time he executed the contract and would have become a chose in action. . . . The State of Pennsylvania would have no claim for collateral inheritance tax upon the proceeds of the land, for it had been converted into personalty by the act of the deceased non-resident and the situs of it, as of all his personalty . . . would be his domicile."

[40] For such a decision to arise in the situation here referred to, there would have to be a distinction in the tax statute between the rate of tax on transfers of realty and transfers of personalty (or some similar distinction). There are cases, however, where the court invokes the doctrine (during vendor's lifetime) for the purpose of ordinary taxation, thus taxing the vendor on the realty, as holder of the legal title, and also on his chose in action under the executory contract. See, for example: Perrine v. Jacobs, 64 Iowa 79, 19 N. W. 861 (1884); State v. Rand, 39 Minn. 502, 40 N. W. 835 (1888). *Contra:* Branner v. Thomas, 37 Kan. 282, 15 Pac. 211 (1887).

[41] 67 Misc. 360, 124 N. Y. Supp. 827 (1910).

[42] 94 Misc. 73, 157 N. Y. Supp. 268 (1916) (immaterial that proceeds of contract of sale go to administrator rather than to heirs).

[43] *In re* Boshart's Estate, *supra* note 31; *In re* Russell's Estate, *supra* note 1.

"equitable conversion" the full rank of a "status."[44] All of these New York decisions were in lower court cases. The matter, apparently, has not as yet been considered by the Court of Appeals.

The situation in Pennsylvania is now apparently settled. A recent lower court decision[45] held that the doctrine of equitable conversion has no application in tax cases (under the first vendor situation), being a mere fiction of equity applied (and even then inaccurately) in actions between the parties or those in privity with them. This decision has just been affirmed by the Supreme Court of Pennsylvania. Despite the language in the case of *Arbuckle's Estate*[46] the conclusion now seems inescapable that the doctrine would likewise be rejected in the second vendor situation.

If any conclusion is to be drawn from such a conflicting mass of decisions it is that there is no unanimity of opinion among courts as to the compelling necessity of adopting the "status" theory of equitable conversion in tax cases. But if there is this indifference as to the necessity of applying it in the case of the vendor's interest, there is more than indifference—there is a decided aversion—to applying it to the interest of the vendee.

Nature of the Vendee's interest

If the true nature of the vendor's interest in the executory contract of sale from and after the execution of the contract can be said to be "personalty," then, *a fortiori* the interest of the vendee from the same moment becomes "realty." All of the analogies which the proponents of the status theory seize upon to support their theory of an actual change in the nature of the vendee's interest apply with equal force here. As many general statements are to be found to the effect that the vendee's interest becomes "realty," as to the effect that the vendor's interest becomes "personalty." In each case the same rules apply as to distribution (as between the heir-at-law and the administrator), dower, curtesy, and burden of loss by fire, etc.[47] The conclusion seems inescapable, therefore, that if the status of the vendor's interest is changed sufficiently by the contract to warrant the assessment of a transfer tax thereon, then a corresponding change is wrought in the vendee's interest for the same purpose.

Thus, if the doctrine be applied here it would follow: (1) that a non-resident vendee's interest under a contract for the purchase of land within the state would be taxable, and (2) that a resident vendee's interest in a contract for purchase of land outside the state would be exempt from taxation. One searches the reports in vain,

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[44] This action is all the more significant in view of the fact that New York holds that intangible personalty is taxable only at the domicile of the owner.

[45] Paul's Estate, *supra* note 1.

[46] *Supra* note 39.

[47] *Supra* notes 7 and 8.

however, for cases where such application of the doctrine has been made. Accustomed as courts are to dealing with legal fictions (such as *mobilia sequuntur personam,* etc.), especially with reference to the taxation of intangibles, it is not surprising that the incongruity of treating the vendor's interest as personalty should escape their notice. Where, however, the vendee's estate has a definite sum of money within the state which would normally be taxable, and the doctrine of equitable conversion is advanced as a compelling reason why this money is in fact "realty" outside the state and hence non-taxable, courts see little or no force behind this contention. No decision has been found where the "status" theory has been applied in either of these vendee situations, and in at least one case[48] rejecting this theory the second vendee situation is treated as the *reductio ad absurdum* of equitable conversion as a basis for taxation.

In conclusion, it is submitted that the "change in status" theory of equitable conversion is supportable neither by the history of the doctrine nor in theory—all instances of its application (other than certain tax cases herein discussed) being explainable (and with even greater accuracy) by elementary principles of equity or law, without reference to a conversion. It is further submitted that as a theory of taxation it is incapable of complete absorption into our existing system. Then, as a practical matter, there are already sufficient necessary artificialities involved in the taxation of realty, and of tangible and intangible personalty, without introducing this additional wholly artificial basis—a basis which complicates the whole system without either extending or narrowing the extent of a state's taxing power except in a purely accidental way. Of the court[49] which sees no reason why the "change in status" theory should not be applied in tax cases, the legal pragmatist may be permitted to inquire: (1) What compelling legal reason is there for such an application? and (2) What useful purpose would be served thereby?

K. W. B.

MARSHALING OF SECURITIES—EFFECT OF SUBSEQUENT INCUMBRANCES ON THE "RIGHT" TO MARSHAL—It is a just principle of equity jurisprudence which dictates that a paramount incumbrancer having two funds to satisfy his demands shall not, by his election, disappoint a junior incumbrancer, who has only one of those funds at his disposal.[1] Should the former resort to the doubly charged

[48] *In re* Baker's Estate, *supra* note 41.

[49] *In re* Boshart's state, *supra* note 31.

[1] Cheesebrough v. Millard, 1 Johns. Ch. 409, 412 (1815); Lanoy v. Athol, 2 Atk. 444, 446 (1742); Aldrich v. Cooper, 8 Ves. 381, 388 (1803); BISPHAM, PRINCIPLES OF EQUITY (9th ed. 1915) § 340; 2 STORY, EQUITY JURISPRUDENCE

fund, the latter will be subrogated to the rights of the former in respect to the singly charged fund.[2] This doctrine is but an application of the maxim, *sic utere tuo ut non alienum laedas,* and since it is an equity that exists between creditors of the same debtor, it is necessarily directed against the debtor himself.[3] A court of equity cannot, in justice, sit idly by and allow one fund to be exhausted, to the prejudice of a junior creditor, and to the benefit of the debtor. Little difficulty is encountered in marshaling the securities when, for example, a mortgagor and two mortgagees are involved, but the cases are in utter conflict when a situation of the following sort is presented:[4] *O* mortgages properties No. 1 and No. 2 to *A;* then *O* mortgages No. 1 to *B,* and, finally, No. 2 to *C. A* forecloses and sells both properties, the funds being paid into court. *A* is paid in full, but the residue is insufficient to pay both *B* and *C* in full. *B* insists upon being subrogated to *A's* lien against No. 2, but *C* objects, and the court is then called upon to distribute the proceeds of the foreclosure sale equitably.[5]

(14th ed. 1918) § 853. Chief Justice Gibson, in Ramsay's Appeal, 2 Watts 228, 232 (Pa., 1834), states the proposition in characteristic fashion: "But if there is any rule of principle of equity plainly, positively and incontrovertibly established on the basis of reason and authority, it is that he who may at law control the application of two or more funds, shall not be suffered to use his legal advantages in a way to exclude the demand of a fellow creditor, whose legal recourse is but to one of them. It is one of the most benign influences of equitable jurisdiction, that it adjusts the application of jarring liens according to their priority and value, in such a way as to produce a degree of satisfaction to all commensurate with their rights; than which there can be no purer justice." For a discussion of the origin and development of the doctrine, see 2 STORY, *op. cit. supra* § 856.

[2] As is pointed out in BISPHAM, *op. cit. supra* note 1, § 341, this is the usual method by which relief is obtained. The paramount incumbrancer ought not, in justice, to be compelled to go after one or the other fund. He was diligent enough to obtain sufficient security, and he ought not be hampered in any manner. Mr. Pomeroy says on this subject: "This form of relief (injunctive) is not, in my opinion, warranted by the principle; . . . and it seems to interfere with the prior vested rights of creditor No. 1," 4 POMEROY, EQUITY JURISPRUDENCE (3d ed. 1905) § 1414, n. 6.

[3] "This is an equity against the debtor himself, that the accidental resort of the paramount creditor to the fund doubly incumbered, shall not enable him to get back the other fund discharged of both debts. . . . This right (to marshal) it was not in the power of the mortgagor to defeat by confessing judgments to other creditors, or by contracting subsequent debts," per Strong, J., in Delaware & Hudson Canal Company's Appeal, 61 Pa. 512, 516 (1861).

[4] It is rather generally stated that marshaling will not be allowed to the prejudice of a third party's rights, and the situation described in the text is an illustration of what the authorities mean. See 4 POMEROY, *loc. cit. supra* note 2; 2 Story, *op. cit. supra* note 1, § 870. The use of such a phrase might prove misleading. The problem in marshaling cases of this type is one of balancing equities. Does the equity to marshal outweigh the equity of subsequent mortgagees or purchasers for value? Does the fact that the latter advanced their money with knowledge of the prior incumbrances affect the situation? An equity to marshal will not displace a legal right, so it means very little to say that marshaling cannot be had to the prejudice of the rights of third parties. The very question is, Do they have those rights?

[5] The designation of the various parties in the text is for the sake of convenience, and is used throughout the note.

The source of much of the English law on marshaling of securities is Lord Eldon's opinion in *Aldrich v. Cooper*.[6] Lord Eldon was very careful to state that the general doctrine of marshaling is applicable "if no third persons are concerned,"[7] and in the later case of *Barnes v. Racster*,[8] Vice-Chancellor Bruce, relying on *Aldrich v. Cooper* and on certain dicta in *Averall v. Wade*,[9] decided that *A*, in the case stated above, must be paid ratably out of No. 1 and No. 2, and that *B* and *C* stood in *pari passu*, even though *C* took his mortgage with full knowledge of all prior incumbrances.[10] The law as developed by this case, and by the later case of *Bugden v. Bignold*,[11] has remained the law of England ever since,[12] despite some doubts as to its logic expressed in *Wellesley v. Lord Mornington*.[13] This dis-

[6] *Supra* note 1.

[7] 8 Ves. at 391. The inference is that if third persons are concerned, there can be no marshaling to their prejudice.

[8] 1 Y. & C. C. C. 401 (1842).

[9] Lloyd & G. temp. Sugden 252 (1835). In that case, Sir Edward Sugden referred to Aldrich v. Cooper at length. He stated the general principle of marshaling, and then continued: "This is a narrow doctrine, and cannot generally be enforced against an incumbrancer, who is a mortgagee," at 255.

[10] Barnes v. Racster differed slightly on its facts from the case stated in the text. At the time *B* obtained his mortgage, *A* only had a mortgage on No. 1, but later the mortgagor gave *A* No. 2 as further security. This fact does not alter the result, as the only question is, Did *B* ever have an equity to marshal? The court in this leading English case left the question open (see *infra* note 11), but certainly at the time *A* got his double security, *B* could have marshaled securities, so that the "accidental nature" of *B's* acquisition of his equity should not cause any difficulty. The court in Barnes v. Racster laid some stress on this aspect of the case.

[11] 2 Y. & C. C. C. 377 (1843). This case raised exactly the problem stated in the text, and in addition *C* took his security without notice. With Barnes v. Racster as a precedent, this court had no trouble at all in reaching their conclusion, and one reviewer, writing in 1 LAW TIMES 397 (1843), said the court should have even gone one step further, and paid *C* alone out of the proceeds of No. 2. The court in this case treated *B* as not having looked to property No. 2 for any benefit, and that, therefore, he should not be disappointed in not getting complete relief by throwing *A* exclusively on No. 2.

[12] See Wellesley v. Lord Mornington, 17 W. R. 355 (1869); Flint v. Howard, [1893] 2 Ch. 54; Baglioni v. Cavalli, 83 L. T. 500 (1900). But see Tighe v. Dolphin, 1 I. R. 305 (1905), in which there was a judgment on certain land, and the judgment debtor settled a portion of the lands in consideration of a forthcoming marriage. Then followed a sale of the remainder of the land. "The defendants were subsequent purchasers of the unsettled lands, and cannot disturb the equity which arose by reason of the marriage settlement," at 310.

[13] Supra note 12, at 356: "So far as positive decision goes, it has been decided entirely the other way in Barnes v. Racster; that decision has never been appealed from, but followed in subsequent cases and largely acted upon. . . . There is a great deal to be said in favor of an argument which went to a great extent upon this,—that the person taking the third mortgage must take it subject to all the interest to which the mortgagor himself would be subject." But the court continues: "I cannot say, therefore, on principle that the case of Barnes v. Racster is wrong. It may be that the reasoning on it is not stated very logically, . . . (but) the whole of our law with reference to that subject will not bear very much the test of logical sequence. When you find a case concurred in so long as Barnes v. Racster, it would be very strange to overrule it. If ever we are to overrule it, it must be on very strong grounds."

position of the problem seems to be more in harmony with the basic nature of marshaling, and it is perhaps attributable to the absence of a recording system at the time the law crystallized. This fact kept the English courts from dealing with the question of presumed notice, but when one of the facts in the case is that *C* took his mortgage with notice in fact of the prior incumbrances, there is little to be found in support of a result like *Barnes v. Racster*.[14]

The decided cases in this country are in conflict. Many jurisdictions adopt the English view,[15] while equally as many courts, following a dictum of Chancellor Kent in *Clowes v. Dickenson*,[16] have reached a contrary result, and have practically accorded the equity to marshal the effect of a lien.[17] The latter group of courts consistently deal with the question of notice,[18] Pennsylvania, for example, presuming that *C* took his security with notice of the prior incumbrances and their legal effect.[19] All courts are apparently in accord on one

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[14] It should be noted that the English decisions leave the door open to the practice of fraud on the part of *A*, the debtor. There is nothing to stop him from giving *C*, a friend, a mortgage on the second property, reducing to that extent the amount that *B* would otherwise get. Of course, if a court of equity even suspects the presence of fraud in the case, *B* and *C* will not be treated equally, but the possibility is still present, and it may be for this reason that a number of American jurisdictions have reached an opposite result.

[15] Leib v. Stribling, 51 Md. 285 (1878); Bates v. Boston El. R. Co., 187 Mass. 328, 72 N. E. 1017 (1905); Green v. Ramage, 18 Ohio 428 (1849); Gilliam v McCormick, 85 Tenn. 597, 4 S. W. 521 (1886) (the leading American case supporting this view, containing a well-reasoned opinion). See Richards v. Cowles, 105 Iowa 734, 75 N. W. 648 (1898); Newby v. Fox, 90 Kan. 317, 133 Pac. 890 (1913).

[16] 5 Johns. Ch. 235 (N. Y. 1821). Speaking of the status of successive purchasers from a judgment debtor, the Chancellor says: "In this respect, we may say of him, as is said of the heir, *he sits in the seat of his grantor,* and must take the land with all its equitable burdens; it cannot be in the power of the debtor, by assigning or selling his remaining land, to throw the burden of the judgment, or a ratable part of it, back upon *A*."

[17] Bank of Commerce of Evansville v. First Nat'l Bank, 150 Ind. 588, 50 N. E. 566 (1898); Hunt v. Townsend, 4 Sandf. Ch. 543 (N. Y. 1847); Robeson's Appeal, 117 Pa. 628, 12 Atl. 51 (1888); Bank of Orangeburg v. Kohn, 52 S. C. 120, 29 S. E. 625 (1897); Conrad v. Harrison, 3 Leigh 532 (Va. 1832). It is said that the result reached by these courts gives marshaling the effect of a lien for the reason that it takes precedence over the rights of a bona fide mortgagee or purchaser for value.

[18] See *infra* notes 19 and 28.

[19] See Robeson's Appeal, *supra* note 17, at 635, 12 Atl. at 56: "The appellees, in the absence of proof to the contrary, will be presumed to have taken their mortgage with full knowledge of all the facts disclosed by the record, and would thus be affected with notice of all the equities, which, owing to the peculiar condition of the respective liens the appellants had as against the Woods judgments." *Cf.* this passage from Green v. Ramage, *supra* note 15, at 429: "We think the rule cannot be applied in a case of this kind. The principle is one established for the purpose of securing to parties the rights to which under the principles of natural justice, they are entitled. . . . When Green (*B*) took his mortgage, he had notice of the mortgage of Wilson (*A*), on lot No. 14 (No. 1). When Hillier (*C*) took his mortgage on lot 39 (No. 2), he had notice only of the liens of Wilson (*A*), which was all the incumbrance on it. There was nothing connected with Wilson's lien that was even calculated to put him on inquiry in

situation, namely, where *C* is a judgment creditor or a volunteer. Both the American and the English courts then say that *C's* rights can rise no higher than *A's*, and since *B* could enforce his equity against *A*, he can avail himself of its benefits against *C*.[20]

From this brief survey of authority it is evident that a correct solution to the problem can only be obtained by a true understanding of the nature of marshaling. The courts perfunctorily call marshaling an equity, without considering its weight and effect. Marshaling is essentially and fundamentally an attempt so to apply "jarring liens" as to cause the least amount of friction. The courts do not refer to this equity as a fixed, indisplaceable right, and yet many American courts must treat it as such, if they accord to one claiming under the equity priority over a *bona fide* purchaser for value without actual notice of the existing situation. Of course, the courts say that there is notice, in law, but as will be pointed out later this seems an unwarranted presumption. When marshaling is considered from a strictly equitable viewpoint, the English view seems to be the better one. The court should marshal as of the time the interested parties are in court asking for relief; but it does not follow that the situation that existed at the time the various liens were acquired should be disregarded. The equity to marshal existed from the time the situation giving rise to the equity was created, and, therefore, when *C*, in our hypothetical case, took his mortgage with notice of an incumbrance prior to his, and also with notice of *B's* mortgage, there is no principle of justice which should protect him—he should be treated as having taken subject to all the equities that arose from the relation of those prior incumbrances. *C* cannot consistently say that he is not chargeable with knowledge of the nature of the equity, for he is now in court attempting to take advantage of that very principle—to have *A* paid ratably out of No. 1 and No. 2.

Looked at in this light, the actual decision of *Barnes v. Racster* seems wrong, but it does not follow that the later English cases are also wrong, for in none of them did *C* have notice in fact of the prior liens.[21] It is true that the criticism just indulged in is based on

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reference to Wilson's mortgage on lot 14, because Wilson's liens on these two lots were created by separate instruments. But if Wilson's liens on the two lots had been created by a single mortgage, Hillier was not bound to notice the situation of lot 14, having nothing to do with it." Notice, apparently, plays an important part in the decision of the case, for the inference is that if there was no notice in fact, a different result might be reached.

For a recent case touching on this question, see Riverside Apartment Corp. v. Capitol Construction Co., 152 Atl. 763 (N. J. 1930), where the court says that *C*, in that case, took with notice, although the case does not bring out that there was notice in fact—152 Atl. at 769.

[20] See Reynolds v. Tooker & Hait, 18 Wend. 591 (N. Y. 1836); Ramsay's Appeal, *supra* note 1; Averall v. Wade, *supra* note 9.

[21] *E. g.*, Bugden v. Bignold, *supra* note 11; Wellesley v. Lord Mornington, *supra* note 12. These courts approve Barnes v. Racster, and, therefore, inferentially indicate that they would decide a case of that sort in the same manner.

the assumption that the equity to marshal is something real and fixed before its aid is sought in court, but this seems true—the equity arose the moment *B* took his mortgage. At this stage the equity was so weak that the rights of a *bona fide* purchaser for value without notice could displace it, but the equity should be sufficiently virile not to be defeated by the rights of a subsequent taker with notice of its existence.

The Pennsylvania decisions have passed through an interesting development. The situation in the earlier cases was one where *C* was a judgment creditor, and the courts uniformly held that the judgment creditor must suffer. For example, in *Hasting's Case*,[22] *A* had judgments which were liens on two pieces of property, while *B* had a mortgage lien on but one of them. *B* was permitted to throw *A* on the other property first, despite the protests of *C*, a still later judgment creditor.[23] This result was reached in all cases[24] until *Hoff's Appeal*,[25] in which *C* was a purchaser for value, and the court refused to allow *B* to marshal to *C's* prejudice. This case was distinguished in *Robeson's Appeal*[26] on the ground that *C*, in this case, was a mortgagee and not a purchaser.[27] It is submitted that this distinction is a specious one; a mortgagee in this situation should be entitled to the rights of a purchaser for value. The true distinction lies in this—the court in *Robeson's Appeal* went on a theory of presumption of notice, while the court in *Hoff's Appeal* treated the purchaser as having taken *bona fide* without notice. *Robeson's Appeal* is, in fact, an overruling of *Hoff's Appeal*. A happier solution might have been found in putting the burden of proving notice on the person attempting to secure the benefits of the equity to marshal.[28]

H. N. S.

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[22] 10 Watts 303 (Pa. 1840).

[23] The court used rather broad language: "This equity, it must be observed, existed on the part of Humes (*B*) before Alexander (*C*) acquired his lien on the property as a security for the payment of his debt; . . . Alexander must be considered as having taken or obtained his judgment and lien subject to the prior equity of Humes; *qui prior est in tempore, potior est in jure*", 10 Watts at 305.

[24] See Dunn v. Olney, 14 Pa. St. 219 (1850); Delaware & Hudson Canal Company's Appeal, *supra* note 3.

[25] 84 Pa. 42 (1877). Says the court: "It is clear, therefore, that Hoff (*B*) has no equity which he can work out, except by displacing a bona fide purchaser, who is prior in time (?), superior in claim on Phillips, the common debtor, and who must lose all his money in case he is displaced."

[26] *Supra* note 17.

[27] "It will be observed that Reiff (*C*) was a purchaser, not a mortgagee, and Phillips, under the implied covenant in his deed, was bound to make the title good to him; he was a bona fide purchaser for full consideration wholly paid, without notice in fact of the lien of the judgment," 117 Pa. at 635, 12 Atl. at 56. The quotation from this case referred to *supra* note 19 on the notice point seems to cover a purchaser as well as a mortgagee.

[28] The court, in effect, is imposing upon *C* a duty of running back every chain of title connected with a blanket mortgage, to ascertain whether any latent

DISPLACEMENT OF PRIOR LIENS BY RECEIVER'S CERTIFICATES ISSUED TO PRESERVE THE PROPERTY OF A PRIVATE CORPORATION BY CONTINUING ITS BUSINESS—Two conflicting legal interests have contributed to the confusion in the law of receiver's certificates issued as paramount liens upon property in the receiver's hands, at every stage in the development [1] of this comparatively modern extension of equity jurisdiction.[2] The application of the rule that it is the duty of a court of equity to preserve property coming into its hands for the greatest ultimate benefit of all parties concerned, and hence to borrow money on prior lien certificates in order to accomplish this end,[3] has been opposed and checked by the general policy of our law, founded upon constitutional declarations,[4] to render the highest possible protection to obligations of contract.[5] It is not to be inferred, however, that direct rulings on the constitutional question have

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equities exist. To impose such a duty is contrary to the spirit of our Recording Acts, the policy of which is to remove secret liens. To charge *C* with notice is to give B a secret lien on a property, the existence of which lien is not discernible from the title to that property.

The question of notice is so thoroughly gone into by most of the American cases because of the presence of recording systems. The notice problem is the important one to be considered, but to presume notice is probably going too far. Prospective purchasers or mortgagees of real estate are rightly considered to be on notice of prior liens on the property concerned, but the equity to marshal is one that can only be uncovered after, what may be in some cases, a most exhaustive and unreasonable search.

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[1] "It is only against railroad mortgagees that the Supreme Court of the United States has sustained orders giving priority to receiver's certificates . . . ," Farmer's Loan & T. Co. v. Grape Creek Coal Co., 50 Fed. 481, 482 (S. D. Ill. 1892); "It is the exception, and not the rule, that priority of liens can be displaced," Hooper v. Trust Co., 81 Md. 559, 592, 32 Atl. 505, 514 (1895) (if this power is extended beyond railroad liens, then no mortgage liens will be secure from the court's action); Raht v. Attrill, 106 N. Y. 423, 437 (1887) (rigid rather than liberal construction of the court's powers to protect the integrity of contracts); Dalliba v. Riggs, 11 Idaho 364, 372, 82 Pac. 107, 109 (1905).

[2] The first important case on the precise point of the present discussion involved a railroad corporation, Meyer v. Johnston, 53 Ala. 273 (1875); see Fid. Ins. T. Co. v. Roanoke Iron Co., 68 Fed. 623, 624 (W. D. Va. 1895).

[3] Union Trust Co. v. Ill. Midland R. Co., 117 U. S. 434, 455, 6 Sup. Ct. 809, 820 (1886); Farmer's Loan & T. Co. v. Grape Creek Coal Co., *supra* note 1, at 481; see Sav. Bank v. Ball-Bearing Chain Co., 118 Iowa 698, 703, 92 N. W. 712, 713 (1902).

[4] "The rights of the citizen, lawfully acquired by contract, are under the protection of the constitution of the United States and, like the absolute rights of the citizen, are not dependent for their existence or continuance upon the discretion of any court whatever," Hanna v. Trust Co., 70 Fed. 2, 8 (C. C. A. 8th, 1895); see Lockport Felt Co. v. United Paper Co., 74 N. J Eq. 686, 690, 70 Atl. 980, 981 (1908).

[5] "We emphasize this fact of the sacredness of contract liens, for the reason that there seems to be growing an idea, that the chancellor, in the exercise of his equitable powers, has unlimited discretion in this matter of displacement of vested liens," Kneeland v. American Loan Co., 136 U. S. 89, 98, 10 Sup. Ct. 950, 953 (1890); see Hooper v. Central Trust Co., *supra* note 1.

arisen to impede this growth in the power of the chancellor through the receiver in his capacity of court's official representative. Rather is the argument of unconstitutionality employed as an additional factor going to make up the general policy against displacing vested contract liens.[6] It is stated as a general rule that the receiver's broad discretion does not include the power to issue such certificates without the authority of the court,[7] and holders thereof take them subject to the final ruling of the court.[8] As opposed to this, it has also been held that "all equities in favor of the certificates should be liberally construed".[9] Although this necessary authorization is said to rest entirely within the discretion of the court[10]—". . . undoubtedly a power to be exercised with great caution; and, if possible, with the consent of all the parties interested in the fund"[11]—the courts have universally recognized that this power to displace vested liens is limited by the necessities of preservation.[12] Of course, if there is a showing of consent or estoppel such that the vested lienholders

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[6] See cases *supra* notes 4 and 5.

[7] Sav. Bank v. Ball-Bearing Chain Co., *supra* note 3.

[8] "They [certificate holders] had at least constructive notice of Freeman's mortgage lien, and are chargeable with knowledge that he was not a party to the suit; that any certificates issued by the receiver were subject to his rights, and that by final action of the court the validity or security of the certificates might be prejudicially affected," Crump v. First National Bank, 229 Ky. 526, 534, 17 S. W. (2d) 436, 439 (1929); Union Trust Co. v. Ill. Midland R. Co., *supra* note 3.

Generally, it may be said that the authority of the receiver to issue certificates is fixed by the terms of the order of his appointment, Sav. Bank v. Ball-Bearing Chain Co., *supra* note 3, and if the decree authorizing issuance does not in terms disclose whether the certificates shall be a prior lien, the decree is construed in connection with the prayer, Karn v. Rorer Iron Co., 86 Va. 754, 11 S. E. 431 (1890); see 1 CLARK ON RECEIVERS (2d ed. 1929) §§ 460, 462.

[9] Montgomery Coal Corp. v. Allais, 223 Ky. 107, 3 S. W. (2d) 180 (1928); *cf.* Crump v. First National Bank, *supra* note 8.

[10] It has been said that equity courts have the power in every case to authorize the issuance of certificates, but the propriety of such issuance is a matter of discretion, 2 TARDY'S SMITH ON RECEIVERS (2d ed. 1920) § 541. However, "such power is not an arbitrary, capricious one, but can be resorted to only in the exercise of sound judicial discretion . . ," Van Valkenburgh v. Ford, 207 S. W. 405, 412 (Tex. 1918); *cf.* Hanna v. State Trust Co., *supra* note 4.

[11] Bradley, J., in Wallace v. Loomis, 97 U. S. 146, 163 (1877); Lockport Felt Co. v. United Paper Co., *supra* note 4; Karn v. Rorer Iron Co., *supra* note 8. As to the necessity for notice to all parties, see 1 CLARK, *op. cit. supra* note 9, § 477; 2 TARDY'S SMITH, *op. cit. supra* note 10, § 563.

[12] However, courts of equity have no jurisdiction to issue certificates which shall be a lien on lands in another state, and it is necessary to apply for and obtain a separate order in each of the jurisdictions in which property of the corporation lies, Lockport Felt Co. v. United Paper Co., *supra* note 4.

But it has been held that the fact that the certificates become a lien on land in one jurisdiction does not prevent the use of the money obtained on such certificates to protect property out of the jurisdiction, if such use tends to protect the property on which the lien has attached, Title Insurance and T. Co. v. Calif. Development Co., 171 Cal. 227, 152 Pac. 542 (1915).

cannot be heard to object to the displacement of their priorities,[13] the chancellor's power to authorize the issuance of the certificates cannot be questioned. The scope of this article does not permit consideration of the varying degrees of estoppel that may be found sufficient to justify the displacement of prior liens in different situations where the loans are made for purposes more or less closely identifiable with necesities of preservation. In passing, it must suffice to say that the courts will not permit a secured creditor to stand by, where there is a possibility that some benefit will accrue to him from an issuance of paramount lien certificates, and then demand his priority if the expected profit cannot be realized.

The overwhelming current of authority being in accord with the rule that the receiver of a private corporation [14] may borrow money upon certificates constituting a paramount lien upon the receivership property only for the purposes of preserving that property,[15] nothing would remain to be said upon the subject were it not for the lack of criteria for determining what constitutes "preservation".[16] The modern tendency of courts to become more and more responsive to demands for the protection of economic interests has inspired an extraordinary growth in this jurisdiction of equity courts based upon the necessities of preservation. Modern corporations have created demands for legal protection that could only be met by a newly formulated theory of procedure, peculiarly adapted to the needs of such economic units. Especially has this distinction been recognized in the case of receiverships of railroads, and quasi-public corporations. How far has this line of reasoning been applied in extending the jurisdiction of courts of equity in regard to private corporations where it is desired that the business be continued while in the hands of the receiver? As pointed out by the United States Supreme Court in the case of *Barton v. Barbour*,[17] two types of preservation, recognized either expressly or implicitly by the courts, must be distinguished; (1) preservation in the strict sense, or preservation of the

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[13] Cox v. Snow, 47 Idaho 229, 273 Pac. 933 (1929) (good collection of authorities); Raht v. Attrill, *supra* note 1 (no estoppel where trustee of bondholders is not a party nor has notice prior to the order for issuance); R. I. Hospital Trust Co. v. Greene Corp., 150 Atl. 74 (R. I. 1930) (estoppel by failure to appeal); Cement Co. v. Bass Foundry Co., 26 F. (2d) 348 (C. C. A. 6th, 1928).

[14] The right to issue receiver's certificates seems never to have been conceded in the case of an individual, Fisher v. Southern L. & T. Co., 138 N. C. 90, 50 S. E. 592 (1905).

[15] *Contra:* Hooper v. Trust Co., *supra* note 1 (receiver may act to preserve the property, but not by means of prior lien certificates).

[16] As said by Andrews, J., in the leading case of Raht v. Attrill, *supra* note 1, "It would be difficult to define by a rule, applicable in every case, what are the expenses of preservation which may be incurred by a receiver by authority of the court," *cf.* Regent's Canal Iron Works Co., L. R. 3 Ch. Div. 411, 427 (1875): Cox v. Snow, *supra* note 13, at 234, 273 Pac. at 935 ("the question of whether a certain purpose is one of 'preservation' or something else is purely relative").

[17] 104 U. S. 126, 135 (1881).

property from physical destruction,[18] and (2) preservation of the ceded purpose for which certificates may issue,[20] discussion must largely turn on consideration of the scope of the second classification as developed in the decided cases—where the receiver has been authorized to do more than merely hold the property intact pending realization [21] or reorganization.[22] Perforce of the language found throughout the cases, the very general statement must be made that whether or not there is an absolute equitable power to displace preexisting liens in order to obtain funds for the purpose of carrying on the business, and thus preserve the property of the corporation at its operating value, will usually depend upon whether the property in the receiver's hands may be classified as that of a quasi-public or private corporation.[23]

Quasi-Public as Distinguished from Private Corporations

Depending upon the exigencies of the particular case, it has been recognized since the leading cases of *Meyer v. Johnson* [24] and *Fosdick v. Schall,*[25] that receivers of public utilities may operate them at the cost of the mortgagees' priorities.[26] The question that naturally arises as to what constitutes a quasi-public as distinguished from a private corporation may best be explained by a consideration of reasons given by the courts in support of the exercise of this extraordinary power in the case of the former. Fundamentally, the inherent nature of railroad property demands for preservation pur-

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18 Farmer's Loan & Trust Co. v. Grape Creek Coal Co., *supra* note 1; Hanna v. State Trust Co., *supra* note 4; see 1 *Clark, op. cit. supra* note 9, § 463.

property in its existing condition as an economic unit in active operation.[19] Since preservation in the strict sense is the universally con-

19 See Cox v. Snow, *supra* note 13, at 235, 273 Pac. at 935; 1 CLARK, *ibid.*

20 But see Hooper v. Trust Co., *supra* note 1.

21 For the length of time included in "pending realization", see Farmer's Loan & Trust Co., v. Grape Creek Coal Co., *supra* note 1, at 481 ("protected and preserved before sale"); Dalliba v. Riggs, *supra* note 1; *cf.* Cox v. Snow, *supra* note 13, at 238, 273 Pac. at 936 (receivership cannot be unduly prolonged, but cases show period may be as long as four or five years); Raht v. Attrill, *supra* note 1, at 434; Boothe v. Summit Coal Co., 63 Wash. 630, 116 Pac. 269 (1911) (hold and preserve property pending principal litigation).

22 For a discussion of the receiver's certificates problem involved in this rapidly growing branch of the law, see Rodgers, *Rights and Duties of the Committee in Bondholders' Reorganization* (1929) 42 HARV. L. REV. 899, 912.

23 Farmer's Loan & T. Co. v. Grape Creek Coal Co., at 482; Raht v. Attrill, at 436; both *supra* note 1; Note (1909) 22 HARV. L. REV. 373.

24 *Supra* note 2.

25 99 U. S. 235 (1878).

26 See 1 CLARK, *op. cit. supra* note 9, § 465; HIGH, RECEIVERS (4th ed. 1910) § 398c *et seq.*; Wham, *Preference in Railroad Receiverships* (1928) 23 ILL. L. REV. 141 (full discussion and citation of authorities).

poses that it be continued in active operation;[27] firstly, to eliminate private loss by the prevention of (a) rapid decay incident to the disuse of such property, and (b) reduction of the property to its "junking" value on forfeiture for nonuser. Secondly, to satisfy the public demand for the services of such public utilities.[28] This fact and the knowledge of lienholders that they acquire their bonds subject to displacement in favor of public service[29] are sufficient answers to constitutional objections. A third line of reasoning supports the first and second on the ground that the state has an interest in continued operation derived from its contribution of the right of eminent domain,[30] and corporations which are denied this right cannot benefit by the quasi-public corporations rule.

Through the lack of these factors, the scope of preservation purposes is defined to exclude continuation of the business except in the case of corporations such as railroads.[31] Thus, a navigation company was held to be outside the rule, because it lacked the right of eminent domain.[32]

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[27] As said by Mr. Justice Blatchford in Union Trust Co. v. Ill. Midland R. Co., *supra* note 3, "The character of the property gives character to the particular species of preservation which it requires. Unimproved land may be idle, with only payment of taxes. Improved property should be rented. Movable property that is not perishable may be locked up and kept; but if perishable, it must be sold, by way of preservation. A railroad, and its appurtenances, is a peculiar species of property. Not only will its structures deteriorate and decay and perish if not cared for and kept up, but its business and good will will pass away if it is not run and kept in order. Moreover, a railroad is a matter of public concern. The franchises and rights of the corporation which constructed it were not given merely for private gain to the corporators, but to furnish a public highway; and all persons who deal with the corporation as creditors or holders of its obligations, must necessarily be held to do so in the view, that, if it falls into insolvency and its affairs come into a court of equity for adjustment, involving the transfer of its franchises and property, by a sale, into other hands, to have the purpose of its creation still carried out, the court, while in charge of the property, has the power, and, under some circumstances, it may be its duty, to make such repairs as are necessary to keep the road and its structures in a safe and proper condition to serve the public. Its power to do this does not depend on consent, nor on prior notice"; Fid. Ins. T. Co. v. Roanoke Iron Co., *supra* note 2, at 625.

[28] *Ibid.;* Barton v. Barbour, *supra* note 17 ("But the public retain rights of vast consequence in the road and its appendages, with which neither the company nor any creditor or mortgagee can interfere").

[29] See quotation of Blatchford, *J., supra* note 27.

[30] Bound v. South Carolina Ry. Co., 50 Fed. 312, 315 (D. S. C. 1892); Van Valkenburgh v. Ford, *supra* note 10, at 415.

[31] Farmer's Loan & Trust Co. v. Grape Creek Coal Co., *supra* note 1, at 482; see 1 CLARK, *op. cit. supra* note 9, §§ 469(a), 470; HIGH, *op. cit. supra* note 26, § 312 b.

[32] Bound v. South Carolina Ry. Co., *supra* note 30, at 315 (a merely "public use is different from a public interest in the use"); see Van Valkenburgh v Ford, *supra* note 10, at 414 (public and private purposes, but private were dominant).

The Texas Supreme Court alone has questioned the sufficiency of these distinctions,[33] but this tendency to depart from the general rule seems to have been totally obliterated by the trend of the more recent decisions by that court.[34] It is also worthy of mention that, in the case of a shipbuilding company, the Supreme Court of Pennsylvania upheld the issue of certificates as a primary charge upon the general funds in the hands of the receiver.[35] However, there is direct authority more recently to the effect that the consent of the prior lien creditors must be obtained before certificates issued by the receiver of a private corporation will be valid.[36] Thus, the universal rule is phrased without dissent throughout the cases that only necessities of preserving the property of a private corporation can justify the receiver in granting priority of security to his creditors.[37] But since, in some situations, "purposes of preservation" are construed by the courts to include the continuation of the business of a private corporation, the rule accomplishes little in the way of furnishing a definite line of demarcation between preservative and non-preservative purposes incident to such continuation. Whatever rules may be found in solution of this problem must be discovered

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[33] "It is not clearly seen that the courts have the power to appropriate any part of the property subject to a mortgage in the interest of the public, or to impair the mortgagee's security or the obligation of their contract, in order to discharge a duty the mortgagor owes to the public. But when the court has taken control of property [whether of a quasi-public or private corporation] and has placed it in the hands of a receiver, it is its duty so to direct its management as to preserve its value for the benefit of all parties at interest. This may best be accomplished by continuation of the business, although such continued operation may involve the danger of some loss," Ellis v. Water Co., 86 Tex. 109, 23 S. W. 858 (1893); *cf.* Lockport Felt Co. v. United Paper Co., *supra* note 4, at 694, 70 Atl. at 983 (quotation *infra* note 37).

[34] Craver v. Greer, 107 Tex. 356, 179 S. W. 862 (1915); Van Valkenburgh v. Ford, *supra* note 10.

[35] Appeal of Neafie, 9 Sadler 284, 12 Atl. 271 (1881).

[36] Steel Co. v. Iron Works, 23 Pa. Dist. 828 (1914). But on the ground of enhancing the security of the bondholders, the Supreme Court allowed certificates to constitute a lien prior to existing liens in the case of a railroad, Rutherford v. R. R. Co., 178 Pa. 38, 35 Atl. 926 (1896) (96% of bondholders consented).

[37] A popular and much-cited statement of the rule is that expressed in the case of Lockport Felt Co. v. United Paper Co., *supra* note 4, at 694, 70 Atl. 983, "The rule which forbids the displacement of prior liens by receiver's certificates, at all events in the case of private corporations, is not the reasonable rule. It goes too far. It may well be that one of the chief reasons for appealing to the court to appoint a receiver is that the property may be protected from spoliation or destruction, and if, after the court shall have assumed to care for the property, it finds that there is no income to support it, and that the court has no authority to pledge the property for its own preservation or realization, the original action in appointing the receiver would be futile. Under no circumstances would the court be justified in authorizing its receiver to borrow money and make the obligation thereof a first lien on the property of a private corporation by the displacement of existing liens for the mere purpose of continuing the business in which the company was engaged, unless possibly in the case in which it satisfactorily appeared that the continuation of the business was absolutely essential to the preservation of the property in the receiver's custody."

only by careful analysis of the cases as a body of factual law. Very little aid is obtainable from a study of the statutes on the subject which are usually little more than codifications of the common law.[38] Doubtless, the dearth of statutes authorizing the displacement of prior liens without the consent of the vested lienholders may be traced to a fear in the legislators as to the constitutionality of such legislation, in view of the obvious impairment of the obligations of contract involved.[39]

The Scope of Preservation in the Case of Private Corporations

Due to the complexity and variety of factual situations in the individual cases, clarity is furthered by reference to a typical case: *X*, a private corporation, is insolvent. *Y*, a junior mortgagee or creditor, whose claims cannot be realized presently, files a bill alleging the insolvency of *X*, praying for the appointment of a receiver with authority to manage and continue the business and for an order restraining all holders of liens prior to *Y's* from foreclosing the same, to the end that the receiver may not be harassed in his conduct of the business. "When a receiver is appointed under such a bill, he usually makes haste . . . to assure the court, that if he only had some capital to start on, he could greatly benefit the estate by carrying on the business that bankrupted the corporation."[40] Since *X* is insolvent, the funds for carrying on the business can only be obtained by subverting the liens of prior mortgagees who alone object, being the only parties who have nothing to gain by the court's venture into business at their risk. When continuation of the business is allowed, the outcome has been almost uniformly disastrous, with the result that the case is brought to the court of appeals by the senior mortgagees in an attempt to set aside the order authorizing the receiver to give his creditors a paramount lien. The appellate court is then called upon to determine the degree of security to which the holders of certificates may be entitled. Of course, the certificates issued for the necessary preservation of the physical structure of the property will be allowed to take prior to the senior mortgagees, *e. g.*, payments of insurance premiums,[41] and for the services of a watchman.[42] Cer-

[38] A statute providing that, "Courts of equity have full power, on good cause shown, to dissolve or close up the business of any corporation, to appoint a receiver therefor, who shall have authority by the name of the receiver of such corporation (giving the name), to sue in all courts, and to do all things necessary to close up its affairs as commanded by the decree of the court," was construed, in Standley v. Hendrie etc., Mfg. Co., 27 Colo. 331, 61 Pac. 600 (1900), as authorizing the issuance of first lien certificates only for necessary preservation expenses.

[39] See II TARDY'S SMITH, *op. cit. supra* note 10, § 554.

[40] Hanna v. State Trust Co., *supra* note 4, at 7.

[41] Montgomery Coal Corp. v. Allais, *supra* note 9; Lockport Felt Co. v. United Paper Co., *supra* note 4.

[42] Porch v. Agnew, 57 Atl. 546 (1904) (to prevent forfeiture of insurance under terms of policy).

tificates issued for the payment of taxes will also be allowed priority, since this "is simply changing the form of the lien from one for taxes for one for money borrowed to pay the taxes.[43] Ordinarily, the courts hold that this enumeration completely outlines the scope of preservation purposes. and certificates issued for other operating expenses may not attain priorities to pre-existing liens. However, there are some situations where the expenses incurred are not so definitely operating costs as to prevent their being judicially construed as necessary for preservation.

A. As to Continuation to Prevent Forfeiture or Foreclosure

In a recent case,[44] the Federal District Court in the Southern District of California upheld the issuance of certificates as prior liens for the purpose of continuing the business of a land development company in order to preserve its rights with the irrigation district. Since the value of the property in the receiver's hands was more than sufficient to satisfy all expenses of the receivership plus the objecting lienholder's claim, after the payment of secured claims prior thereto, the dissenting mortgagee could not be injured by the issuance, while the benefit to be derived from continuance was obviously considerable. It seems that no practical objection can be offered against such a holding confined to its facts, but the case represents an abnormal situation in this branch of receivership law whereas the normal case involves insolvency. Thus where the facts varied to the extent that the claims of the creditors might possibly have been jeopardized by the issue of paramount lien certificates, the Federal District Court of Delaware [45] granted authority to issue the certificates, but without priority. We may discard at once the clear case of impracticability of success, for no court will force the dissenting bondholder to assume the risk of speculative enterprising on the part of the receiver.[46] However, where the speculative nature of the adventure is not at issue, the courts hold conflicting opinions as to whether, having issued the certificates. the holders thereof may enforce their liens prior to the mortgagees. One view maintains that such payments are preservative in nature. since they tend to the general benefit of all parties concerned, including the objecting mortgagee. all of whose interests would be impaired by forfeiture. The New Jersey Court, in *Lockport Felt Co. v. United Paper Co.*,[47] adopted this line of reasoning and upheld the issuance of certificates to pay a redemption

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[43] Hanna v. State Trust Co., *supra* note 4, at 9; Cox v. Snow, *supra* note 13.
[44] Toole-Tietzen & Co. v. Colorado River Development Co., 38 F. (2d) 850 (S. D. Cal. 1930).
[45] Spackman v. Orchard Co., 274 Fed. 107 (D. Del. 1921) (corporation solvent—no benefit to objecting lienholders, but possible jeopardy to their claims).
[46] Van Valkenburgh v. Ford, *supra* note 10; see Cox v. Snow, *supra* note 13, at 238; 273 Pac. at 937.
[47] *Supra* note 4.

installment and interest to the first mortgage bondholders in order to prevent foreclosure. As opposed to the constitutional objection, the analogy to the case of a franchised public utility is at once apparent. But the inapplicability of this analogy is emphasized by the fact that the courts which adhere to the view of the New Jersey court do so on the ground of the actual preservation effected, after asserting that continuation of the business as such would be permissible only in the case of quasi-public corporations.[48] Although preservation of the property supplies the basis for jurisdiction in either class of corporations, the above-mentioned distinctions recognized by the courts are doubtless sufficiently strong to carry the point. However it is not clear how the logical perfection of the rule accounts for the factual objection that the business is in fact carried on by the receiver.

The other view adopted by the courts also distinguishes the situation from that of quasi-public corporations, but its adherents prefer to find that continuing the business is outside the scope of preservation purposes.[49] Since, practically, objections to continuance only arise where there is a probability of loss such that the objecting mortgagee is not willing to take a risk at the hands of a receiver which the private entrepreneur could not vindicate, the doctrine of the New Jersey Court would seem to fall within the constitutional objection to continuance. If the analogy to quasi-public corporations might be drawn, the court's doctrine could be sustained in spite of the unconstitutionality argument. However, even were the courts holding to the New Jersey view not so stanchly opposed to drawing that analogy, the result would still be open to the criticism that the mortgagee's rights are subverted by an unwarranted resort to a doctrine akin to that of salvage as applied in admiralty law.[50] It may also be argued that the rule creates an element of uncertainty in fixed obligations with a consequent tendency to discourage investors from accepting a form of security which is indispensable to the operation of private corporations. Nevertheless, the *Lockport Felt Company Case* has become the most widely cited case on this point, and there

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[48] Title Insurance and T. Co. v. Calif. Development Co., *supra* note 12; McDermott v. Pentress Gas Co., 82 W. Va. 230, 95 S. E. 841 (1918) (to prevent lapsing of lease—the court expressed its disapproval of issuance for operating expenses); *cf.* Ball v. Improved Property Co., 247 Fed. 645 (C. C. A. 2d, 1917) (to prevent forfeiture of lease, the most valuable asset); Printing Co. v. Hotel Co., 118 Mo. App. 44, 93 S. W. 337 (1906). But see Sav. Bank v. Ball-Bearing Chain Co., *supra* note 3, at 710, 92 N. W. at 716 (long lease will not warrant receiver in continuing speculative business).

[49] "For the court, by an order of this sort, to displace existing liens, would certainly be very doubtful as to its propriety, if, indeed, it would not be an entirely illegal act . . ," Newton v. Eagle Phoenix Mfg. Co., 76 Fed. 418 (N. D. Ga. 1896). But see the opinion by Learned Hand, J., in Ball v. Improved Property Co., *supra* note 48.

[50] See note (1909) 22 HARV. L. REV. 373, 374.

is little doubt that the courts will continue to recognize the prevention of forfeiture as a necessary preservative purpose.[51]

B. As to Continuation to Increase Saleable Value

The situation in which this question arises is factually identical to the previous one except that the objections of the mortgagee are met by the argument that continuation of the business presents a likelihood that the saleable value of the property will be increased. Here, the Kentucky rule is illustrative of the general feelings entertained by courts of equity in considering this question. In the Kentucky case of *Montgomery Coal Co. v. Allais*,[52] certificates were allowed to come in prior to the mortgage lien, on disposition of the property after sale, only to the extent of the increase in value produced by the issue of certificates. Thus, the court's authority to grant the issue was made to depend upon the success of the receiver's venture. Doubtless, the result of such a rule cannot be criticized from the viewpoint of the objecting mortgagee, since the court having gone into business, it is not reasonable to allow the investors therein to obtain a priority of claim to investors whose rights were fixed under the previous, private administration of the business. Certainly, the rule cannot be said to work a hardship upon those who have prayed for continuance of the business, since (1) they cannot demand benefits at the expense of prior lienholders [53] and (2) if the business cannot be operated with sufficient expectation of success to encourage investment without insurance of its return, then it may be argued that clearly there is a case where it would be unwise for the court to authorize continued operation. On the other hand, such a rule is anomalous and must fail of practical operation. Since, the only proper security available to certificate purchasers in the last analysis is that created by the operations of the receiver, investors will not be found willing to accept such security in a business that failed under the usually more efficient private operation. A more unconscionable result is reached where the receiver grants priorities over the prior vested obligations only to have his promise overruled by the appellate courts. To permit this state of affairs is to discourage the highly desirable market for certificates when their sale is sought for the purpose of actual preservation. Manifestly, an investor cannot be expected to recognize the difference between preservation and other uses to which the receiver may apply his loan and he most certainly will not assume the risk of the receiver's assurances being overruled.

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[51] McDermott v. Pentress Gas Co., *supra* note 48; See R. I. Hospital Trust Co. v. Greene Corp., 50 R. I. 305, 146 Atl. 765 (1929) ("If the property is liable to be lost by foreclosure of a mortgage, or is imperiled by failure to keep up insurance . . ," there is no question of the propriety of issuing certificates for these purposes).

[52] *Supra* note 9.

[53] Hooper v. Trust Co., *supra* note 1.

Hence, the issuance of certificates has been upheld, in some instances, on the ground that the certificate holders had relied on the court to confirm the act of its officer and protect them from loss at his hands.[54] But this liberal treatment has not been accorded to petitioners before the majority of courts and the New York court, in the case of *Raht v. Attrill,*[55] unyieldingly protected the rights of the bondholders as against the purchasers of certificates.

However, aside from the Kentucky view, which does not appear to have been adopted by any other court, there is a line of cases which have actually allowed certificates to displace pre-existing liens on the general ground that their issuance preserved the property by increasing its saleable value. At the head of these is *Karn v. Rorer Iron Company,*[56] in which the building of a bridge was held to be a valid preservative purpose, since, without it, the iron ore in the mines could not have been marketed and the property would have been of no "commercial value." The construction of a small mining railway running over the bridge was completed by the receiver and the court seems to have lighted upon this railway factor as sufficient grounds for drawing the analogy to the case of quasi-public corporations.[57] Doubtless, much can be said for the practical force of the analogy, but, again, an attempt to thus extend the rule in the case of private corporations is met by opposition in the form of the universal rule with its unwavering distinction between the two classes of corporations. It seems, therefore, that the court's previous "reason" affords a more normal ground for the decision. In *McDermott v. Pentress Gas Co.,*[58] after the stereotypical reiteration of the rule that only in the case of quasi-public corporations would continuance of the business be a sufficient purpose for allowing displacement of prior liens, the court upheld continuation for a long enough period to put the property in a saleable condition. In the course of his discussion, Judge Lynch expressed the opinion that the distinction between the two classes of corporations as to the necessity for continued operation is merely one of degree. This statement also is typical and adds nothing of definitive value, especially in the light of the court's conclusion that the distinction must be maintained for the protection of fixed obligations. Whenever a tacit, practical analogy may be drawn, in the judicial mind, to the case of a quasi-public corporation, it seems that these apparent extensions of the rule will continue to be upheld on the ground of preservation. But where the same economic necessity, that exists in quasi-public corporations, is not

[54] Kneeland v. Luce, 141 U. S. 491 (1891); Dalliba v. Riggs, *supra* note 1; see Montgomery Coal Co. v. Allais, *supra* note 9. But see cases *supra* note 8.

[55] *Supra* note 1.

[56] *Supra* note 8.

[57] The court quotes a passage from the opinion by Bradley, J., in Wallace v. Loomis, *supra* note 11, which case involved a railroad in the hands of a receiver.

[58] *Supra* note 48; *cf.* Toole-Tietzen & Co. v. Colorado Development Co., *supra* note 45.

present to motivate the court, such extension would not seem to be warranted unless in the form of the Kentucky rule which in the last analysis subverts the interests of no one.

C. As to Actual Operating Expenses

To allow continuation of the business, as such in the case of a private corporation—merely to produce profits—under the guise of preserving its property is to render mere "lip-service" to the established rule. Consequently, decisions permitting such judicial enterprising are rare. However, in view of the general tendency among the modern chancellors to devolve upon receivers the considerable task of salvaging the whole ship from the wreck in order that all claimants may be satisfied, a discussion of these extreme cases of judicial discretion would seem to be in order. Of course, the fact that consent or a judicial finding of estoppel will at once dismiss the problem must not be ignored. A recent example of this type of case is one decided by the Supreme Court of Rhode Island,[59] wherein part of the loan to the receiver was used to purchase new machinery to be used in the dyeing and bleaching business. Many of the cases which purport to sustain actual operating activities on the part of the receiver are thus reconcilable on the broad ground of estoppel.[60] However, the Rhode Island court on a former appeal of the same case, held to the effect that if the continuation of the business was for the benefit of the lienor, then to so continue the business must be an act of preservation as regards the lienor though he objects to continuance.[61] Thereupon the court gives as examples, such businesses as involve the operation of oil and mining property. As stated by a well-known text-writer,[62] ". . . Such properties on account of peculiar working conditions are often surrounded with conditions and circumstances which make their continued operation imperative as a means of preservation." Here again it is the peculiar nature of the property that gives rise to the necessity for continuing the business of the corporation—almost a perfect analogue to the quasi-public corporation situation on the theoretical basis of the *Barton v. Barbour*[63] reasoning. It has been said[64] that the conflict which exists in these cases, as to whether a necessity for operation in fact exists, is not real, but arises from the fact that the status of the property in question rendered the refusal to grant authority to continue the business a proper one under the circumstances. A few cases have adopted this

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[59] R. I. Hospital Trust Co. v. Greene Corp., *supra* note 13; see the former opinion on the case, reported in 50 R. I. 305, 146 Atl. 765 (1929).

[60] See cases *supra* note 13.

[61] R. I. Hospital Trust Co. v. Greene Corp., *supra* note 51.

[62] II TARDY'S SMITH, *op. cit. supra* note 10, § 558.

[63] *Supra* note 17.

[64] II TARDY'S SMITH, *op. cit. supra* note 10, § 558.

line of reasoning,[65] while an overwhelming number of courts have refused to allow the issuance on the sole ground of want of authority.[66] In *McDermott v. Pentress,*[67] the West Virginia Court of Appeals, although stating the general rule that receiver's certificates should not be used for the general purpose of operation, recognized that the necessities of the situation required drilling operations to be undertaken by the receiver in order to preserve the oil property.[68] It would seem that the *Barton v. Barbour* theory should also be applicable to the case of an irrigation company, and a California decision,[69] where the authorized receivership operations were extensive, clearly points in that direction. In no case does it seem that the analogy to the necessities of preservation in quasi-public corporations is stronger, yet the California court distinguished the case from that of railroad receiverships and upheld the issuance as necessary for preservation.[70] In a state where irrigation has become fully as essential to the economic welfare as quasi-public corporations, it is surprising that the California Court preferred factual contradiction to violation of the categorical integrity of the general rule. One other situation is worthy of comment, *i. e.,* where the lienholder objects to a displacement without which his interest in the property would have been utterly worthless.[71] Here, again we have an unusual case, for doubtless the lienholder should have consented to the displacement of his lien, if approached, since he could only be benefited thereby. Theoretically, as to his rights, the continuation could be nothing if not preservative.

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[65] Karn v. Rorer Iron Co., *supra* note 8; McDermott v. Pentress Gas Co., *supra* note 48 (Oil Co.); see Montgomery Coal Corp. v. Allais, *supra* note 9; Central Trust Co. v. Pittsburg R. Co., 52 Misc. Rep. 195, 101 N. Y. Supp. 837 (1906) (mine).

[66] Farmer's Loan & T. Co. v. Grape Creek Coal Co., *supra* note 1; Fid. Ins. T. Co. v. Roanoke Iron Co., *supra* note 2; Nowell v. International Trust Co., 169 Fed. 497 (C. C. A 9th, 1909); Dalliba v. Riggs, *supra* note 1; for full citation of additional authorities, see note (1926) 40 A. L. R.. 244.

[67] *Supra* note 48.

[68] "The power granted to encumber by operating expenses and by the drilling of additional wells, except to meet the imperative necessities of the situation, and the appropriation of the income to meet these expenses, and, when this is exhausted, to displace the liens by receiver's certificates, cannot result otherwise than detrimentally to the rights and interests of the secured creditors, if continued longer than reasonably necessary to obtain a fair market value for the estate of the insolvent corporation." *Ibid.*

[69] Title Insurance and T. Co. v. Calif. Development Co., *supra* note 12. But see Hanna v. State Trust Co., *supra* note 4.

[70] The court merely invoked its discretion in deciding this question, saying, "It is sufficient to say, in answer, that our own reading of the record satisfies us that there was ample evidence to justify the conclusion that all of the expenditures authorized by the court were required for the actual care and preservation of the property committed to the receiver's custody." *Ibid.* at 231, 152 Pac. at 566.

[71] Lunsky v. The Criterion Construction Co., 151 Atl. 490 (N. J. 1930) (receiver authorized to complete construction of apartment house in the stead of defunct construction company); (1931) 31 COL. L. REV. 170.

Beyond the few isolated situations herein outlined, in which continuation of the business may be most easily reconciled with the idea of preservation, no courts have deemed it wise to venture. An even balance of economic and legal principles must necessarily require a curtailment of further extensions either tacitly, on the grounds of preservation, or expressly by exception to, or inclusion within the general rule. Such extensions would, (1) either inequitably enhance the security of one group of investors at the expense of another, or (2) have the sole and singular justification of having set the receiver up in business by supplying an insured six per cent. investment to certificate holders.

A. F. B.